Mobile Embrace (MBE)

Pure play on mobile advertising and M-commerce

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Three Key Points

- MBE's rapid growth is driven by underlying organic market growth, new technologies from acquisitions and growth of direct carrier billing. New markets offer more growth, aided by the growing technology stack from acquisitions and increasing demand for direct carrier billing.
- I believe that over the longer term group EBITDA margins can expand to nearer 20%, driven by putting new Australia marketing technologies through the UK and other markets.
- Forecast 3 year EPS CAGR of 88.7%. I have a target price of 55c, MBE is cheap. 55c would be 21.2x P/E FY17. The All Ords trades on 16.7x FY16 for 8% EPS growth, and 14.8x FY17 for 9.2% EPS growth.

Pure play on smartphone usage

Mobile Embrace is compounding 6 value creation strategies/key drivers of earnings growth:

1: Theme of growing Australian mobile marketing and mobile commerce

2: New technology improving customer acquisition in terms of quality, cost and margin (Vizmond)

3: Improved ROIs for customers from better digital marketing technology (Performance marketing)

4: Taking improved Australian based technology to the UK market through their recent acquisition (Punch)

5: Opening up new markets and putting current Australian-based technology through them (Telenor deal, and Malaysia)

6: More bolt on Acquisitions bringing newer and better technology to their group footprint in line with their core value proposition

If they can deliver on our growth forecasts MBE looks remarkably cheap. We feel the main risks to the investment case are:

Increase in ad blocking

Increasing competition driving up the cost of customer acquisition

Erosion of relationships with content providers

Competitors developing superior technology

Loss of direct carrier billing contracts

I think the route to revenue of $100m+ is relatively clear and I feel this management team will continue to over deliver as they have in the past.

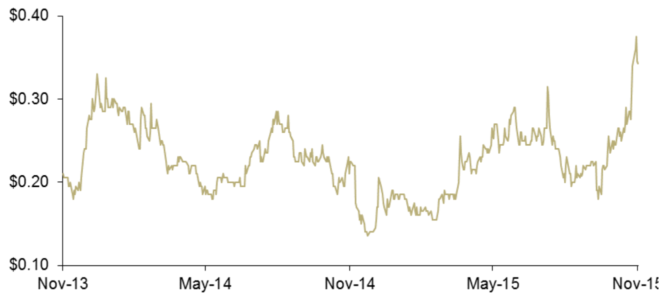
Recommendation	Buy
Previous Recommendation	
Risk Rating	Medium
Current Share Price	$0.34
12 Month Price Target	$0.55
Price Target Methodology	Technical
Total Return (Capital + Yield)	62%
DCF Valuation	
Market capitalisation	$136m
Liquidity – Daily Value	$0.6m

Financial Forecasts & Valuation Metrics

Y/e Jun ($m)	2015A	2016F	2017F	2018F
Revenue	33	60	103	162
NPAT	2.9	4.9	10.3	19.0
EPS (cps)	0.7	1.2	2.6	4.7
EPS Growth	0%	64%	109%	85%
DPS (c)	0.0	0.0	0.0	0.0
EV / EBITDA (x)	25.3	15.2	7.2	3.6
PER (x)	45.9	27.9	13.3	7.2
Dividend Yield	0.0%	0.0%	0.0%	0.0%
Gearing	-42%	-42%	-47%	-56%
Interest Cover (x)	na	na	na	na

Source: PhillipCapital estimates

MBE share price performance



Source: PhillipCapital estimates

55c target price 62% upside

55c target price, see 62% upside in the near term

I see 62% upside in the near term driven by earnings growth and a re-rating.

Owing to the strong earnings growth and strong theme driving the stock we feel MBE should trade on 22x forward P/E. As such in September next year we expect MBE to trade at 55c, or 21.2x FY2017 EPS. The All Ords trades on 16.7x FY16 for 8% EPS growth, and 14.8x FY17 for 9.2% EPS growth.

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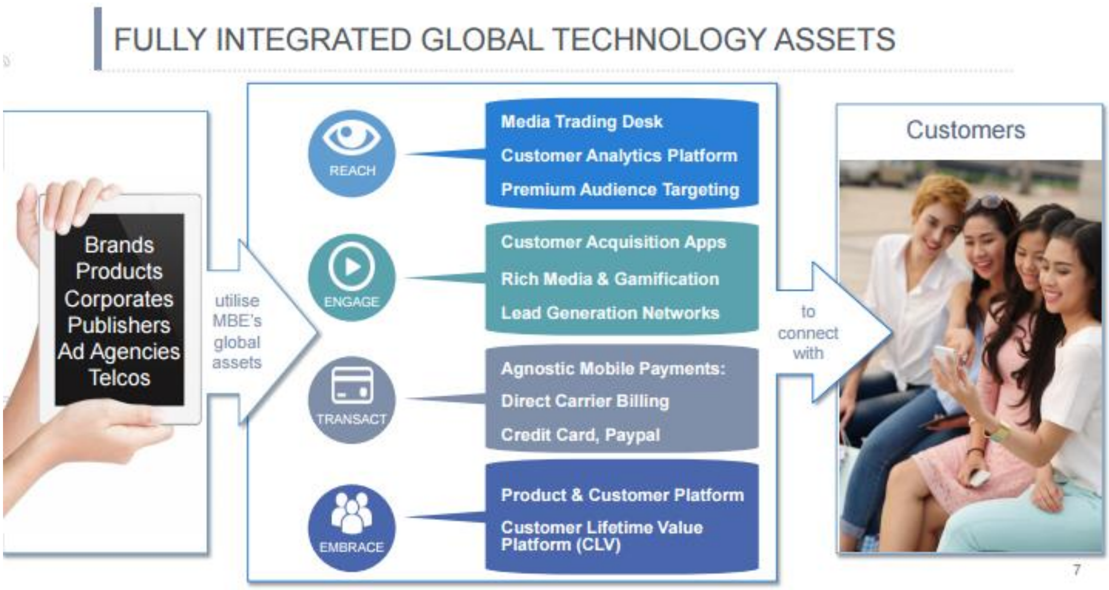
Mobile Embrace and the buy side

Mobile embrace is a reasonably well known small cap having been owned by most of the small cap mafia, including myself, from September 2013 to its highs in January 2014.

However I feel this has worked against the stock, as the business has changed and improved immeasurably. In our eyes it is worth another closer look.

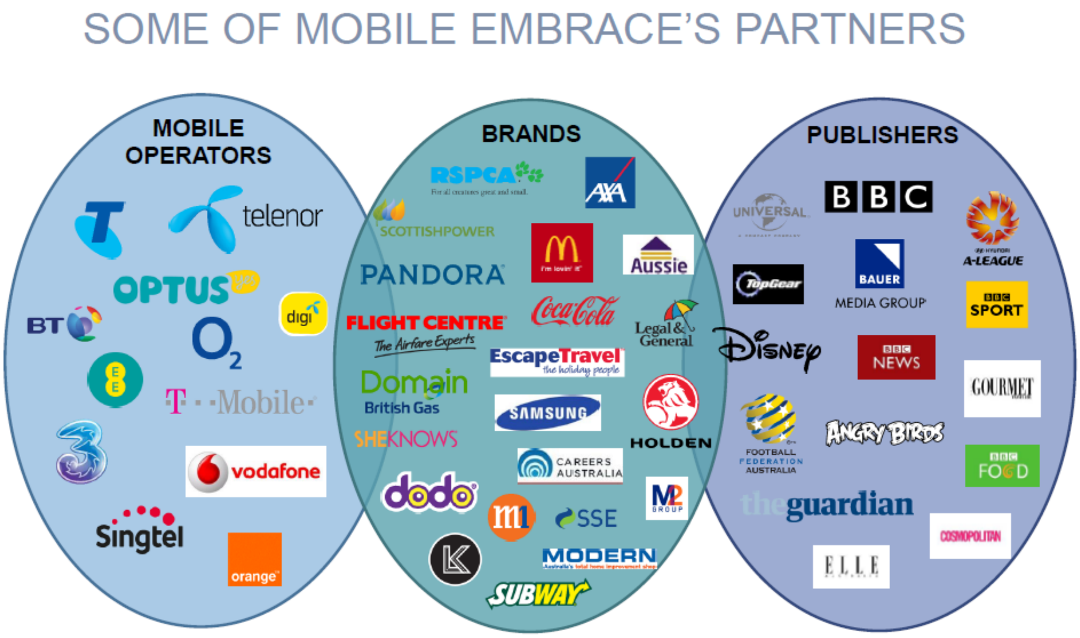
How do they make money?



Source: MBE company presentation

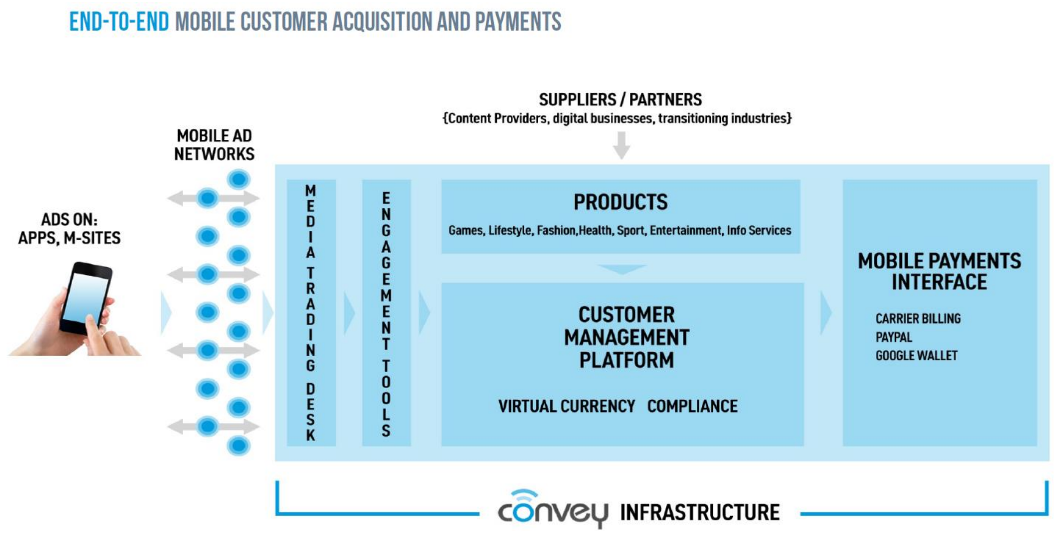
MBE uses their network of relationships built up with content providers and publishers to get paid to deliver customer leads and customer acquisitions through its mobile marketing and billing infrastructure brand and product impressions, as well as provide billing services as what I would call a 'merchant acquirer in Mobile'. Examples of publisher clients are Bauer, News Corp, the Guardian and the BBC. These are clearly not second rate players.

MBE has direct carrier billing arrangements with the below listed mobile operators. They place adverts within their own publishing assets and have agreements to place adverts within the content of their affiliated publishers. Some of their marketing clients are listed below.

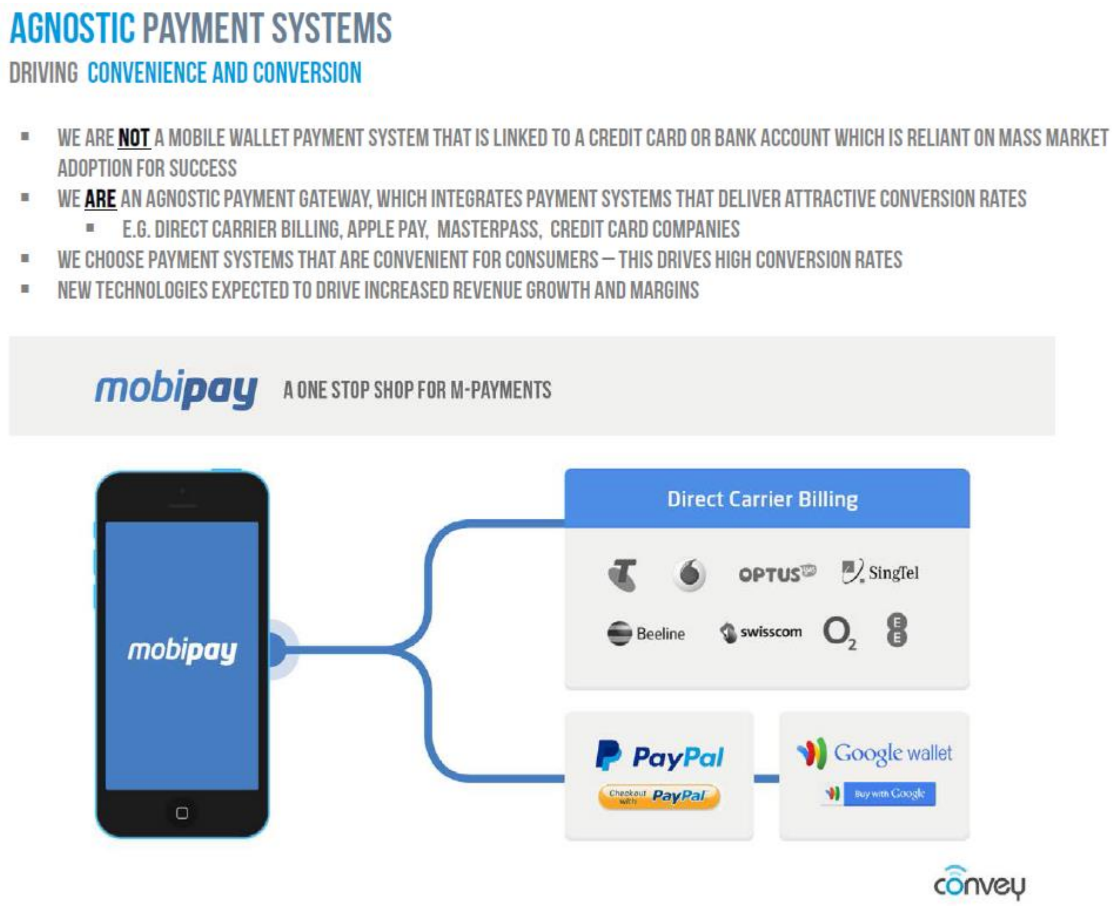


Source: MBE company presentation

As a merchant acquirer their payments model is described well in two slides from MBE's April 2015 presentation seen below. It is important to recognise that they are a system agnostic payment services provider, hence why I see them as a 'merchant acquirer' in Mobile commerce.



Source: MBE company presentation



Source: MBE company presentation

Mobile embrace strong play on developing theme:

Smartphone increased usage and increased screen size has been driving MBE's profit growth, MBE is a clear play on this theme.

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1: Theme of growing Australian mobile marketing and mobile commerce

Mobile advertising is currently around $120-140m, at present growing 30-40% annually. So there is still room for MBE to grow strongly domestically, although with so many differing estimates from industry players, is it difficult to handicap market share and growth too much. FB and Google are >50% of AUS mobile advertising market.

MBE Australia segment grew 72% over FY15.

Starting to see decent competition now in the AUS market, eg. In the direct carrier billing segment they face Bonjourno (owned by NTT Docomo), amongst others.

2: New technology improving customer acquisition in terms of quality, cost and margin (Vizmond acquired 4th August 2015)

The Vizmond acquisition is key to further growth. It does reduce the cost of customer acquisition, but more importantly it improves the quality of the customer leads for marketing, as it complements the performance marketing business at MBE.

Vizmond's algorithms record customer details that they enter when they click through on an advertisement. When you click through you are required to opt-in and put in your personal details to enter the competition.

The art is in the type of adverts, and how many personal details Vizmond can get from a lead.

Before Vizmond's acquisition at the full year customer acquisition via in-house networks was up by 123%. Vizmond will only improve this figure. In-house channels are key to keeping the cost of customer acquisition down.

3: Improved ROIs for customers from better digital marketing technology (Performance Factory acquired 21st Nov 2014)

Performance marketing (from the Performance Factory business) improves ROIs for customers, Performance factory has a strong positon in the market particularly their ROIs. ROI is the key metric here for advertisers, and prices can be increased once performance marketing has demonstrated conversion rates.

Performance Marketing is complimentary to current M-Marketing offerings, and helps build on current achievements. The premium publisher network expanded to reach more than 65% of Australia.

There are two main areas of performance marketing's offering:

App installs:

A customer wants to drive installations of their app. They pay performance marketing to put advertisements in content that say "do you want to install XXXX" when people click yes and install the app MBE takes their fee.

Call centre enquiries:

Like app installs, it is the ROI performance that drives returns for MBE. Adverts are placed in content and apps affiliated with MBE (here their lead generation network is key). The adverts say, for example, "do you want super-fast broadband at $29.99 a month with no lock in contract? Dodo offer" If the person clicks yes, that message gets passed on to the customers' call centre who immediately make a phone call sales pitch. The psychology is clear, once a human has already said yes, it is hard not to give their full attention to the call.

MBE gets paid for generating the lead and passing the lead's details onto the customer.

Dodo is a main client for performance marketing in Australia, utilising their call centre.

MBE is also seeing strong demand from the careers industry. The technology and business offering is applicable to anyone who wants to generate leads, and it is having a suitable lead that is key, improving on the scatter gun approach that call centres more normally still employ.

4: Taking improved Australian based technology to the UK market through their recent acquisition (Marketing Punch, acquired 29th Sep 2015)

The acquisition of UK Marketing Punch brought a standalone profitable business into the group. The real promise lies in future development opportunities for the UK.

The opportunity exists to push the Vizmond and Performance Marketing technology stack through the UK business. It should drive large revenue and margin improvements.

In addition, MBE is putting their mobile payments through their UK operations. They now have access to all the major UK mobile telcos on a direct carrier billing basis.

5: Opening up new markets and putting current Australian-based technology through them (Telenor deal, and Malaysia)

The Telenor deal signed in 2014 produced an opportunity for MBE to move into foreign markets where Telenor has a presence. The Malaysian market is the first example of this, but in due course we expect MBE to move into Telenor's other markets. In addition to the Nordic home markets of Telenor, they are active in Malaysia (opened), Thailand and Myanmar.

6: More bolt on Acquisitions bringing newer and better technology to their group footprint

Acquisitions bring new technology, new clients and new management. It's important to look at the shareholdings in MBE of the young entrepreneurs. They vended into MBE because they saw the potential the group offered to take their businesses forward. They have strong shareholdings themselves in the business and are tied in.

Acquisitions, eg UK Marketing Punch, can accelerate MBE's entry into new markets for the benefits for shareholders.

Clipp is more of a new vertical than the bolt on acquisitions MBE have made recently. MBE has only a 30% stake in clip, but has a convertible note which would take their ownership up to 72%. Clipp increases foot traffic for bars around Australia, they take a 2% clip of transaction value, they hope they can move up to the 5% mark. The app can clearly add value to hospitality businesses, although it is early days. The app also reduces credit card fraud risk for venues and decreases shrinkage. Clipp has 20k users and around 500 venues signed up so far, but with performance marketing there is significant scope to land grab and get to over 200k users, the required level to be economically positive. Clipp's new DASH offering has started showing its possible effect, the announcement from the 12th November 2015 highlights how DASH has driven revenue increases at venues of 150% when used.

Is it a quality management team?

I define a quality small cap management team on the following characteristics:

Do what they say they will do

Management that has over delivered on previous growth plans

Management have strong internal control and management systems & practices

Understand their industry, and have a clear direction to take advantage of trends

Have the vision to build their business internationally and in new verticals

Drive strong ROEs

Continuously focused on shareholder value creation rather than their own egos, even if that means shrinking the balance sheet

Investors will make their own mind up on the subjective question of whether this is a quality management team. Chris Thorpe and Neil Wiles founded MBE ten years ago, and have been running the business continuously since then. I believe this management team ticks all the boxes above. Their internal management systems are first class, at any moment management can see all the dynamic variables in the business by the minute.

Chairman Drew Kelton brings a wealth of experience from his roles as Executive VP of T-Mobile USA, President of Bharti Airtel India and MD of Telstra international. Drew brings management experience and a great ability to open doors.

Has the business got a good market position?

The business is in a strong market position in Australia. It is the dominant player and increasing its reach and reputation, especially since the acquisitions of Vizmond and Performance Factory.

The real test of MBE's market position, technology wise, is when they try and rollout the Australian operations in the UK and other markets.

Is it a good theme?

Smartphone marketing, so a pretty good theme in a country with increasing unemployment pressure, a housing market that is clearly peaking (Two major estate agents IPO'ing), over capacity in ore production with weakening Chinese demand, and finally a skills & technology shortage to take advantage of the weak AUD through manufacturing exports.

Is it good value?

FY17 MBE is on 13.3x P/E and with a 3 year EPS growth CAGR of 88.7% and an outlook for future growth. The All Ords trades on 16.7x FY16 for 8% EPS growth, and 14.8x FY17 for 9.2% EPS growth.

Will MBE's technology still be leading the field in 5 years' time?

Very very tough question to answer. But ultimately key to investing in these fast growing new technology businesses.

Mobile marketing will still be around in 5 years' time and the market will certainly be a lot bigger than it is now. The question is whether their technology will still lead in the market place? Will they stay innovative? Can they buy more innovative businesses and protect themselves that way?

This is key to deriving a multiple valuation. I believe MBE will still be in a market leading place through their own innovation and through acquisitions if they so need.

Risks:

Ad Blocking

Ad blocking has been mainstream in Mobiles for over 3 years now, desktops over 10 years. The value of desktop advertising and mobile advertising per unit has increased dramatically over this period. MBE has been growing it's revenue in the environment of Ad blockers.

Ad blockers are at serious odds to any app developer or content provider, as such almost all will actively work against the ad blocking industry players. Apple will not block ads in applications.

It is difficult to see a future where providers don't create a strong operational opposition to ad blocking applications.

Ad blocking applications also require your phone to run through a 3rd party server, which on top of security risks, also drains your battery life quicker and lowers performance speed.

Yes Ad blocking is a marginal issue and investors need to keep an eye on it, but it doesn't have the industry wide concern that some investors fear.

Better competitors

This is the key risk for this business. That they run into competitors that can acquire better leads cheaper, and produce higher marketing ROIs than MBE.

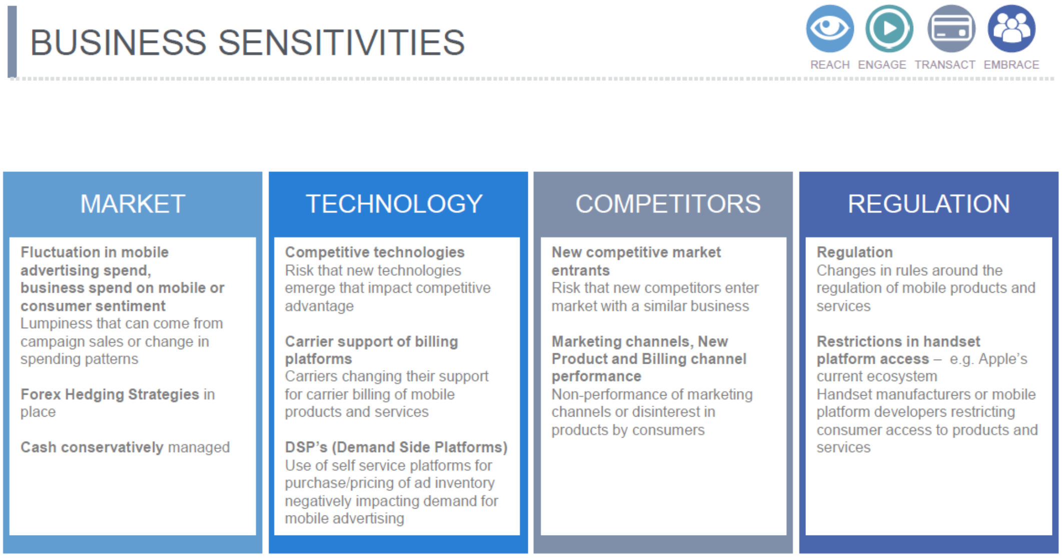
When, undoubtedly, these competitors come along, they will struggle to produce better technology and create better relationships with their publishing networks. It is worth noting that Performance Factory and Vizmond where started my single entrepreneurs very recently. MBE has to watch the competitive space very closely and acquire any business that becomes a threat.

Legal action, no issue

The recent legal claim has been reduced. I do not expect the claim to be awarded against MBE. The supplier had an obligation to supply suitable product to MBE as per the terms of their agreement, which they failed to do. However some legal fees may remain for MBE; I estimate worst case scenario to be $500k.

Other business sensitivities

A fair reflection from management on the below slide.



COMPANY SUMMARY

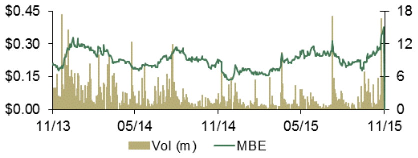
Mobile Embrace Ltd

MBE.AX

Price Information

Price ($/share)	0.34
Mkt Cap ($m)	137
Enterprise Value ($)	126

Share Price & Volume Chart



FINANCIAL SUMMARY

Year End - Jun	FY13A	FY14A	FY15A	FY16F	FY17F	FY18F
KEY METRICS						
EPS Growth (%)	149	415	0	64	109	85
PER (x)	235.1	45.7	45.9	27.9	13.3	7.2
PEG (x)	1.6	0.1	-118.3	0.4	0.1	0.1
P/Free CFPS (x)	-53	159	35	25	12	7
Dividend Yield (%)	0.0	0.0	0.0	0.0	0.0	0.0
EV/EBITDA (x)	na	38.7	25.3	15.2	7.2	3.6
EV/EBIT (x)	290.2	46.0	31.7	17.6	8.0	3.8
ROE (%)	14.6	23.8	14.5	19.6	31.2	39.6
ROA (%)	9.8	41.9	20.9	22.3	38.9	57.5
ROIC (%)	12.8	52.2	23.3	32.0	52.7	76.5
PROFIT & LOSS (AUD $m)						
Revenue	12	19	33	60	103	162
EBITDA	1	3	5	8	16	30
Depreciation & Amortisation	0	0	1	1	2	2
EBIT	0	2	4	7	15	27
Net Interest Expense	0	0	0	0	0	0
Income Tax Expense	0	0	-1	-2	-5	-8
NPAT Reported	0	2	3	5	10	19
Sign. Items & Other	0	0	0	0	0	0
NPAT Adjusted	0	2	3	5	10	19
PER SHARE DATA (cps)						
Shares on Issue (m)	276	320	383	401	401	401
EPS Reported	0	1	1	1	3	5
EPS Adjusted	0	1	1	1	3	5
DPS	0	0	0	0	0	0
Free CFPS	-1	0	1	1	3	5
BALANCE SHEET (AUD $m)						
Cash	0	12	10	12	18	32
Debtors & Inventory	4	4	9	11	15	19
PP&E	0	0	0	0	0	1
Intangibles	1	3	11	12	14	16
Other Assets	0	0	2	2	3	3
Total Assets	5	19	32	37	49	71
Borrowings	0	0	0	0	0	0
Creditors	1	2	5	5	6	9
Other Liabilities	0	1	5	5	5	5
Total Liabilities	1	2	9	9	11	13
Net Assets	3	17	23	28	38	58
BALANCE SHEETS RATIOS						
Gearing - Debt/Equity (%)	-5	-73	-42	-42	-47	-56
Interest Cover (x)	16.7	na	na	na	na	na
Leverage (x)	-0.2	-4.1	-2.0	-1.4	-1.1	-1.1
NTA per Share (cps)	1.0	4.5	3.1	3.9	6.1	10.4
CASH FLOW (AUD $m)						
EBITDA	1	3	5	8	16	30
Interest & Tax	0	0	0	-2	-4	-8
Working Capital Change	3	0	2	2	2	3
Operating Cash Flow	-1	3	5	8	14	24
Maintenance Capex	0	-3	-1	-2	-3	-4
Free Cash Flow	-2	1	4	6	11	20
Expansion Capex						
Dividends	0	0	0	0	0	0
Equity Issues / (Buy Backs)	1	11	0	0	0	0
Proceeds from Borrowings	0	0	0	0	0	0
Other	0	0	-7	0	0	0
Net Cash Flow	-1	12	-3	6	11	20

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Recommendation Criteria

Investment View

PhillipCapital Investment View is based on an absolute 1-year total return equal to capital appreciation plus yield.

Buy	Hold	Sell
>20%	20% – 5%	<5%

A Speculative recommendation is when a company has limited experience from which to derive a fundamental investment view.

Risk Rating

PhillipCapital has a four tier Risk Rating System consisting of: Very High, High, Medium and Low. The Risk Rating is a subjective rating based on: Management Track Record, Forecasting Risk, Industry Risk and Financial Risk including cash flow analysis.

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